TESTIMONY OF

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WASHINGTON, D.C.

ON

THE STRUCTURE OF THE FINANCIAL SERVICES INDUSTRY

BEFORE THE

SUBCOMMITTE ON TELECOMMUNICATIONS AND FINANCE
COMMITTEE ON ENERGY AND COMMERCE
UNITED STATES HOUSE OF REPRESENTATIVES

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Good morning, Mr. Chairman and members of the Subcommittee. We are pleased that you have called these hearings on a most important subject. It is said that there is nothing as powerful as an idea whose time has come and we believe this applies today to the subject of these hearings -- restructuring the financial system. The FDIC's views on financial services reform and the structure of the financial services industry are set forth in our study Mandate for Change: Restructuring the Banking Industry. This study is being submitted today as a part of the official record. The Executive Summary at the front of our study lays out the principal issues and our recommendations for reform.

The Need for Financial Services Reform

Financial markets and competitive forces, both domestic and international, have changed dramatically since 1933 when the Glass-Steagall Act first imposed a separation between banking and securities activities. These changes are addressed at length in our study. Existing restrictions on banking activities have handicapped the banking industry in today's rapidly changing financial environment. This disadvantageous situation slowly will lead to a less safe and sound banking system. Any threat to that system is a threat to the intermediation process, private-sector liquidity, the payments system and the conduct of monetary policy.

Under current conditions, banks are at the heart of the economic system; thus, their continued viability is essential. To be safe and sound, the banking system has to prosper. But, bank supervisors cannot order success. Prosperity can be achieved only if a fair competitive structure is in place. Structural reform is necessary for banks to attract capital and to compete effectively, both at home and abroad.

Key Issues and Questions

Mr. Chairman, I was pleased to read your comments delivered last month in San Francisco before the Annual Institute on Financial Services. Your excellent speech clearly and precisely sets forth basic principles for reform and the challenges facing Congress as a result of changes in the financial services industry. Your fundamental reform principles are very similar to the principles that underpin the FDIC's study. Those principles are:

- Separately capitalized nonbanking affiliates and subsidiaries.

- Rigorous functional supervision of a legal and functional separation between banks and their nonbanking affiliates and subsidiaries.

- Arm's-length transactions between banks and their affiliates and subsidiaries.

- A two-way street for banks and their competitors.

- Rules to minimize concentration.

While you were addressing only securities activities, Mr. Chairman, we believe these principles should extend to all activities considered to be either too risky for banks or inappropriate for the use of insured deposits and the federal safety net. Thus, the securities activities and other activities that Congress deems inappropriate for the bank to undertake directly would be subject to these principles.

The Chairman's speech also raised the following key issue:

> "Will a more fully deregulated system, with increased and careful supervision along functional lines, rather than out-and-out prohibition, better serve our nation's economic interests?"

Our response is a resounding YES! In arriving at that conclusion, we analyzed the same tough preliminary questions raised in the speech.

1. "How can we insulate insured deposits from securities activities?"

That is THE question. It focuses attention on the fundamental issue to financial restructuring: Can we create a wall around banks that insulates them and makes them safe and sound, even from their owners, affiliates and subsidiaries? If a "wall" can be built, then direct banking regulatory and supervisory authority over nonbanking affiliates, or even bank owners, is not necessary. A "supervisory wall" could permit the supervision of banks' affiliates by the appropriate functional authorities and the dismantling of statutes limiting the activities of such affiliates.

Supervising conflicts of interest is the key to an effective supervisory wall. Based on 54 years of supervisory experience, our professional supervisory staff believes that conflicts can be regulated appropriately for safety and soundness and that many of the tools needed are already in place. The views of the professional staff with regard to the regulatory powers needed to supervise conflicts are presented in our study. They are:

- First, retain the limitations on dealings with nonbank affiliates contained in Section 23A of the Federal Reserve Act and extend them to "nonbanking" subsidiaries of banks.

- Second, retain the new Section 23B, just passed by Congress, which specifies that all transactions with affiliates be conducted on an "arm's length" basis. This Section also prohibits any action which would suggest that a bank is responsible for the obligations of its nonbank affiliates, and significantly restricts the purchase by banks of securities in which nonbank affiliates have an interest. Section 23B also should be extended to nonbanking subsidiaries.

- Third, provide authority to audit both sides of any transaction between the bank and its subsidiaries or affiliates.

- Fourth, to the extent necessary, authorize collection of certain financial data from nonbanking affiliates and subsidiaries.

- Fifth, provide clearly defined regulatory authority to require, from either a public-policy or risk standpoint, that any nonbanking activity be housed outside the bank, in either a separately capitalized subsidiary or affiliate.

- Sixth, require that nonbanking subsidiary and affiliate investments be excluded in determining bank regulatory-required capital.

- Seventh, provide authority to prevent any transactions between banks and their owners, subsidiaries or affiliates which are deemed to jeopardize the safety and soundness of the banks.

2. "How can we ensure the continued safety and soundness of, and public confidence in, the banking system -- and in our financial markets as a whole?"

Safety and soundness of, and public confidence in, the banking system <u>can</u> be assured through appropriate supervision. The issue is not whether such supervision can provide complete protection for <u>every</u> bank, but whether it will keep the <u>system</u> safe and sound. It is a fact of human behavior, at least in the United States, that a majority of the people play by the rules when the rules are reasonable. However, a small percentage may not. Thus, the supervisory challenge in creating a "safety and soundness" wall is to identify and restrain the minority who will abuse the system. The view of our supervisors is that with the right tools they will catch at least nine out of ten of the abusers. This percentage would be sufficient to preserve the system's safety.

In addition to the supervisory tools that restrain system abusers, there are other ways to build public confidence in the system. The market will view different units within an organization as distinct corporate entities if they are, in fact, treated that way as a matter of law. As bank supervisors and the courts make distinctions between banks and their holding companies and affiliates, the market will do the same. Thus, problems in an affiliate or subsidiary need not place a bank at risk. To that end, public confidence in the banking system can be maintained.

3. "How can we ensure that banks' privileges do not endow them with improper competitive advantages?"

There are several ways to avoid an improper competitive imbalance. First, competition must be a two-way street. That is, if banks are allowed to enter the securities field, securities firms should be allowed to enter the banking field. This objective would be accomplished by repealing Sections 20 and 32 of the Glass-Steagall Act.

Second, the strict enforcement of restrictions contained in Sections 23A and 23B of the Federal Reserve Act will control conflicts of interest and ensure competitive equality. By building an effective wall around the insured bank and requiring it to deal with its affiliates as it would any unrelated third party, banks and their affiliates will not be endowed with competitive advantages that are not available to all other competitors.

Third, activities that might otherwise have inappropriate access to the bank federal safety net can be proscribed. Any competitive inequalities can be eliminated by constraining access to the payments system, Federal Reserve credit and funding by means of federally insured deposits. Congress may wish to provide a broad outline of the types of activities that may be conducted by banks. In the absence of such guidelines, Congress should designate federal regulators to make the individual decisions regarding appropriate bank activities.

4. "How would we prevent conflicts of interest that would seem to arise naturally out of the relationships contemplated by many banks, such as transactions made at the expense of the bank to heal an ailing securities affiliate."

The FDIC staff has been supervising conflicts of interest effectively over the agency's entire history. The banking industry has inherent conflicts between directors who are both borrowers and directors of the lender. In addition, under current conditions, conflicts are raised by the relationship between parent holdings and the parent's subsidiaries. In both cases, supervision has been effective in preventing the conflicts from jeopardizing the system.

Potential conflicts of interest are not unique to the banking industry. They exist throughout the business world. Despite the widespread potential for abuse, there is little to suggest that conflict-of-interest abuse in the United States economy is at an unacceptable level. Nowhere is this more true than in banking. Evidence has not been advanced suggesting that the potential for abuse has resulted in actual systemic problems. Regulatory supervision <u>has</u> been effective in controlling conflicts.

Conclusion

To conclude, I would like to stress that banking is experiencing and will continue to experience rapid and critical changes. The existing system is inefficient. Government's presence must be modernized. Long-range financial services industry restructuring should be undertaken to improve competitiveness, reduce regulatory costs and provide increased safety and soundness for the financial system. The FDIC has detailed in the accompanying study its views on the action needed. We will be pleased to work with your Subcommittee in its important deliberations.

Thank you. I will be pleased to respond to any questions.